Response to Proposed Rule: Sound Business and Financial Practices

Thank you for the opportunity to respond to FSRA's proposals rule change.

While Parama strongly supports movement to a outcomes/principles based model and the underlying intent behind the proposed rule change – we have significant concerns over the practical implications and costs (both direct and indirect) of imposing system wide requirements for new independent oversight functions, notwithstanding very different strengths and approaches employed by a diverse range of credit unions in achieving intended objectives.

While the comments in this submission are specific to Parama, we suspect that many of the concerns raised herein have universal application to a significant population of other smaller credit unions within the Ontario Credit Union system.

Background

As a small credit union with 6,000 members and less than 30 FTE's, the vast majority of which are involved in delivery of member services and operational support, Parama relies on a lean management team along with a high degree of transparency, a simple business model and a strong risk culture to manage and balance risks on a balance sheet approaching $500million in assets.

As a result, Parama is well positioned to mitigate independence and failsafe concerns within first and second lines of defense through inherent attributes which by their nature may not extend to the full-sized hierarchical financial institutions for which the proposed rule appears to have been intended. These attributes include:

- a flat organizational structure led by a highly qualified experienced, management team, with in depth knowledge and top to bottom expertise in areas ranging from detailed business processes to organizational risk, enabling evolving risks and concerns to be identified early and addressed on a proactive and timely basis,
- a high degree of transparency afforded by a simple and lean management structure which extends to the entire organization through comprehensive and proactive board reporting, and open communication lines throughout the organization,
- lack of organizational incentives intended to promote undue growth or operating results at the expense of risk, within a community-based mandate - thereby significantly reducing scope for conflict between business objectives and risk,
- a simple and stable business model which remains relatively consistent over time; with very few if any transactions or business initiatives which might be considered unusual in nature warranting a stronger level of oversight,
- the ready ability to promote a strong risk culture throughout a small organization supported by risk based KPI's for senior management, members of which tend to be well versed in risk, and
- the ability to efficiently and effectively assign and balance current and emerging business priorities with evolving risks within a small, knowledgeable and competent management group in a lean organization structure.

Provisions in the Proposed rule which require further delineation of responsibilities under designated function heads within the second line of defense raise a number of concerns for an organization such as Parama, including:

- significant scope for redundancy and overlap in an environment which is already subject to independent oversight from a 3rd line of defense, as well as external bodies such as external auditors and various regulatory agencies (to say nothing of existing efforts to support first and second lines of defense).
- potential for misunderstanding/misinformation as individuals tasked with monitoring/overseeing risk may lack the business/industry insights to fully comprehend the nature and rationale for business processes and inherent mitigation measures which are often qualitative in scope (this might be a particular concern with third party contractors who might be prone to reliance on preconceived notions and high-level standardized templates). This may in turn jeopardize the quality and depth of second line areas such as ERM reporting, as responsibility is shifted from individuals intimately familiar with all facets of the business and the industry in which it operates (i.e. CEO / Director of Finance) to an independent party,
- organizational inefficiencies and complexity from new requirements to establish and maintain processes to ensure co-ordination and access between separate functions and business lines. In any event, time spent by the business in supporting proposed risk and compliance functions maintained by independent third parties can be expected to be considerable.
- very significant costs from inevitable increases in resources and the need to develop/maintain documentation trails and reporting/communication processes to bridge and otherwise support decoupled independent function requirements and responsibilities. The proposed rule will almost certainly result in an increase in efficiency ratios and risks producing undue pressure on revenue growth (a common cause of institution failures),
- decentralization of functions and business responsibilities will inevitably result in greater challenges in aligning and reconciling separate organizational risk assessments sourced from a broader population (i.e. ERM & internal audit) with policies & business strategies. The disproportionate representation of function heads in the senior management ranks suggests the subordination of key business initiatives to the maintenance of risk processes,
- dilution of risk culture as organization responsibilities for risk, shift to formalized functions rather than naturally imbedded in the business. Anticipate delays and other inefficiencies in identifying and addressing evolving risks where formal reliance on key information/assessments is placed upon highly structured formalized layers of reporting processes involving a greater number of bodies/parties.
- Increased involvement of democratically elected boards in the management of the business in areas such as management performance

In summary

The proposed rule codifies new layers of functionality, which appear to be better suited to complex hierarchical enterprises which lack the inherent benefits/transparency of smaller organizations in mitigating risk, and by nature tend to be highly dependent upon extensive processes to identify, communicate and manage risks throughout various levels of the organization. It is far from clear whether the introduction of additional layers of oversight and fail safes necessarily produces an improved result over efforts to improve the quality of measures already in place (read third line of defense) when it comes to smaller highly transparent organizations which benefit from a simple business model and imbedded risk processes.

While we acknowledge and otherwise support the intention to apply the proposed rule in a manner which is proportionate to an organization's nature, size, complexity and risk profile – it is highly questionable whether the concept of independence (as mandated for proposed oversight requirements) represents an area which lends itself to discretion in its interpretation. Arguably this represents the greatest impediment for a small organization in designing and developing an effective and efficient approach for achieving desired outcomes in a manner which might be otherwise be considered proportionate to its nature, size, complexity and risk profile.

The introduction of part time consultants to manage a critical second line of defense risks the subordination of in-depth insights into the business (both quantitative and qualitative) in favour of preconceived notions and high-level standardized risk templates.

While the intention to move to greater independence, delineate lines of responsibility and promote layers if fail-safes in oversight functions is commendable, there is a real concern that simply mandating additional layers of oversight will offset many of the benefits which naturally accrue to smaller organizations such as Parama, not only in terms of costs (at both board and management levels) but to transparency and the ability to leverage off benefits which naturally accrue to benefit of the organization.

The introduction of independent functions presents a particularly significant challenge where organizational volumes and business models do not support full time positions for these roles. Weaving these into a lean and effective business model with minimal cost and loss of effectiveness will represent a significant challenge for an organization such as Parama. <u>Practical</u> guidance on the application of the Proposed Rule in a manner "proportionate to the nature size, complexity and risk profile" would prove extremely beneficial to small credit unions tasked with its implementation.

Questions & observations:

- Is there scope for combing oversight functions with other oversight functions or roles, other than that what is specifically contemplated in 13(2) which appears to contemplate the ability to subordinate the Compliance Function to either Finance, Risk or Internal Audit Functions. Please confirm the latter.

  Third party ERM reporting for smaller credit unions which benefit from a simple business model (which remains relatively consistent over time), might in theory involve a brief quarterly visit to incorporate any updates to an assessment template and the compilation / delivery of a report to the board. Would this be consistent with FSRAO's expectations for an oversight function, or is some form of continuous involvement in the business anticipated?

- *1(1)(iv) "senior management" means the following members of management: …*
  (c) the heads of the oversight functions of a credit union

The addition of function heads to an already lean senior management team appears to provide function heads with disproportionate representation in the organization's senior management ranks. It is interesting that that this will create a number of different direct reporting lines to the board – the implications of which remain to be seen and may vary depending upon whether the CEO is a member of the board.

10(2) appears to override 1(1)(iv)(c) to exclude for individuals who are employed by a contractor engaged by the credit union from senior management as the head of a function. It is assumed however that a contracted sole proprietor who performs a service such as ERM which qualifies that individual as the Head of a Function for say a number of institutions is considered senior management of any credit union client for which such services are performed (regardless of how much time is spent at the credit union).

Would the head of the Compliance Function constitute senior management even if the individual were to report to the head of another oversight function as permitted under 13(2)?

- *5(3)(ii) board to …………approve performance objectives, compensation & reviews of senior management*
  9(1) board to create, develop, update and implement remuneration programs for……….senior management

  These requirements appear to create a significant disjunct between responsibility over performance and authority over compensation and performance management, given that members of the senior management team (other than the CEO & proposed function heads) report to the CEO and are not directly accountable to the board. While it is not unusual for management to share performance and compensation information with the board, formalized requirements and processes, including the need to align board efforts in these areas with very specific and detailed business and operational issues, risk further costs and delays.

  The requirement for the board to create and implement remuneration plans for the senior management team represents a significant deviation from what has traditionally been an oversight role for this body (as otherwise contemplated in section 5 of the proposed rule), a particular concern where business input into the development of such plans may be limited.

- *10(5) Individuals primarily responsible for conducting the activities of the credit union's oversight functions shall be independent of the credit union's and its subsidiaries' operational activities and businesses.*
  14(2)(ii) provides the Head of the Finance function the opportunity to <u>participate</u> in material functions of the business

  It is unclear whether 14(2)(ii) is intended to exempt the head of the finance function from the independence requirement in 10(5), or whether there are activities which might otherwise fall under a senior finance role which will now be off-side under 10(5) – i.e. it is assumed that 14(2)(ii) contemplates active participation which extends to direction and execution. In any event 10(5) should not extend to restrict active management of financial strategies which are integral to the business, such as the pricing of loans and deposits, the execution of funding strategies or efforts to improve the bottom line.

Similarly, it is unclear whether references to oversight and independence may restrict direct involvement in operational matters by oversight functions; more specifically:

- 10(5) appears to preclude the head of the risk function from assuming direct responsibilities in areas such as insurance, routine credit adjudication or the development of responses to risk situations or providing input into new products or services. Please confirm.
- It is not unusual for a compliance officer in a small organization to be actively involved in (read own) the development and maintenance of compliance processes. Would this be disqualified under 10(5) or for that matter under the wording of 13(2) which suggests a purely oversight role for the head of this function?

In a small organization it is unrealistic for the level of independence expected from risk or compliance oversight functions to be comparable to that expected from say an auditor which has no responsibility for or involvement whatsoever in matters under audit. Would expectations be different for the compliance function if it were to be subordinated to internal audit versus another function?

- *10(7) provides heads of oversight roles direct and "unrestricted access" to all* Credit Union information

  It is highly disconcerting that a small credit union be required to provide unlimited access to highly sensitive information (i.e. payroll records & administrative rights to data systems) which may or may not have direct bearing on the requester's mandate. This section should be qualified to contemplate "appropriate" access to information required to perform their roles and satisfy their responsibilities.

- *13(1) The compliance function of the credit union shall provide systematic, comprehensive and timely oversight of compliance risks through the identification, measurement, monitoring and reporting of compliance risks across the credit union as a whole and within its specific business lines and units and subsidiaries.*

  Compliance could potentially encompasses a broad range of areas ranging AML and Privacy to regulatory compliance to tax filings *(unclear if tax filings would pose an independence issue if this role were to report to the finance function)*, all of which require highly specialized expertise in different areas (legal, accounting, practical regulatory/business insights), which may simply not be realistic for a single independent function in a small organization particularly where the function may be precluded from direct involvement in compliance processes (refer to commentary under10(5)).

Would the proposals require duplication of oversight efforts in areas such as AML in separate functions (i.e. compliance and internal audit)? Further guidance in this area is invited.

We also look forward to receiving greater insight into FSRA's proposed approach to "outcomes based" and more specifically whether regulatory assessments will focus on true outcomes (along with evidence that the organization as a whole is proactively and effectively managing risks and is otherwise effective in its approach to achieve positive outcomes in the areas designated by FSRA), versus factors specific to actual methods and processes intended to achieve an organizational outcome. The possible need to assign responsibility for functions for which outcomes are being assessed, to independent parties raises the concern that the organization may well end up being penalized over an exercise over which it has little direct control (short of the board becoming actively involved in the ERM process itself) – particularly given inevitable challenges in sourcing a highly qualified third party with both adequate credentials and comprehensive insights into the business.

Additional guidance on this will prove helpful in gauging how much latitude smaller credit unions have, in interpreting these proposals to ensure that credit unions are in a position to meet FSRA's expectations under the proposed rule.

Respectfully submitted,

Parama Credit Union

Per:

Per: Tarmo Lobu, CPA, CA
Chief Executive Officer
Former: Head: Risk Capital Program for the Baltic region (Swedbank)
Advisor: Prudential risk management (Central Bank of Estonia)